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C O N F I D E N T I A L SECTION 01 OF 03 TOKYO 004658

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NSC FOR TONG; USTR FOR BEEMAN AND MEYERS; PARIS FOR USOECD;
DOC FOR 4410/ITA/MAC/OJ/NMELCHER;TREASURY FOR IA/DOHNER,
HAARSAGER POGGI, CARNES, AND WINSHIP; STATE PLEASE PASS TO
FEDERAL RESERVE SAN FRANCISCO/A. MAEDA AND FEDERAL RESERVE
BOARD/J. KOHLI;BERLIN PASS TO FISHER; BANGKOK PASS TO THORIN

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SUBJECT: GOING POSTAL: INTRODUCING THE WORLD'S LARGEST BANK

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¶B. TOKYO 2716
¶C. TOKYO 1916
¶D. TOKYO 967
¶E. TOKYO 894

Classified By: Charge d,Affaires Joseph R. Donovan for reasons 1.4 b/d.

Introduction

¶1. (SBU) Yucho, Japan,s postal bank, is the world,s largest bank, with total assets of 222 trillion yen ($1.9 trillion) and FY 2007 net income of 300 billion yen ($2.6 billion). As Yucho,s privatization began on October 1 (ref a), its sheer size and first steps into new banking businesses promise a significant impact in Japanese and global financial markets.

A Bank is Born

¶2. (U) On October 1, Japan Post dissolved and its functions were doled out to successor companies under the Japan Post Services Holding Company (JPSC). The new successor companies are to be subject to the same laws and regulations that govern their respective private industries. A government corporation will be established as a repository of the pre-privatization savings accounts held by Japan Post. The government will continue to guarantee the existing postal savings obligations and the funds in these grandfathered accounts will be placed in government bonds.

¶3. (SBU) Yucho,s traditional business model had been quite simple: channeling savings back to the government to finance either directly or indirectly Japanese fiscal policy. The most popular postal savings product were the teigaku chokin, a ten-year time deposit account with no early withdrawal penalty after six months. Yucho has also offered passbook savings and other time deposits and, since October 2005, investment trusts. However, Yucho has never had a lending facility.

¶4. (SBU) Since inception, Yucho has not paid any deposit insurance premiums or taxes, has not been subject to capital requirements, has had a government guarantee on its deposits, and historically has set its interest rates for

savings deposits higher than banks. For these reasons, the existence of Japan Post has been criticized by the private sector, which pointed to Japan Post,s unfair competitive advantages.

¶5. (SBU) Yucho,s privatization is expected to increase competition in the banking sector as the bank seeks to offer products and services now offered by private banks. A likely outcome of Yucho,s new status is a privatized postal bank with little or no government support that has to diversify its offerings and asset base. The plan is to eliminate market distortions and subsidized competition to promote the efficient allocation of funds within the Japanese economy. However, risks and questions remain.

But What Kind of Bank?

¶6. (C) Observers and other financial market participants are wondering about Yucho,s business model. Mortgage finance, loans to small and medium enterprises, and finance for public works projects have all been posited as possible business activities. However, there are questions as well as to how Yucho can successfully enter these already highly competitive areas on a meaningful scale and where it will find the needed expertise. There are also questions as to whether the GOJ will allow market forces to operate. There are concerns a financial system already characterized by overcapacity may end up with excessive competition and risk taking, perhaps weakening other financial institutions, including the regional banks and cooperatives, if not Yucho itself.

¶7. (C) One fear is Yucho will continue to be implicitly or explicitly backed by the government and, by using its size and the resulting unfair competitive advantages, lead to problems for the regional banks. Many of the concerns the USG has repeatedly expressed regarding a level playing field, raised most often in the context of the Postal Insurance Company, are designed to ensure that government backing does not aid what would already be a tough competitor in this "strong bank" scenario.

¶8. (SBU) Any new business areas or activities for Yucho must be recommended by the Postal Services Privatization Committee (PSPC). However, as the financial services regulator, the Financial Services Agency (FSA) can deny an application if it deems Yucho does not have the competence to enter into the new area. Japan Post issued an outline of its implementation plan that included new business areas that Yucho might enter, including offering foreign currency deposits, mortgages, business loans, project finance, receivables financing, and credit cards. The document states Yucho would seek to begin these businesses promptly after privatization.

¶9. (SBU) Earlier this spring, an FSA contact indicated that a range of new business might be considered, with varying likelihoods of approval. He suggested the bank was likely to ask for liberalization of risk management tools. He gave hedging operations to limit interest rate risk on the bank,s large portfolio of JGBs as one possible area that could meet with easy approval. More difficult would be loans to small- and medium-sized enterprises. He indicated entry into this field could face fierce opposition from Japanese regional banks, which would be directly affected by such a move. Technically, however, such opposition should not be a factor in the decision.

¶10. (SBU) An example of an attempted foray by Yucho into a new business area played out in recent press articles. Press reports indicated Yucho was preparing to enter the

mortgage market and was soliciting regional bank partners to join in this venture. In a meeting with the regional banking supervisory office at FSA, an official there called the press reports inaccurate, and said FSA was not prepared to approve mortgages as a new product offering at this point. However, he continued, Yucho might be allowed to act as an agent in offering products of the regional banks. In the end, all but one regional bank, Suruga Bank, declined Yucho,s offer of a business tie-up in the mortgage area, with press reports suggesting the result stemmed from regional banks viewing Yucho as more of a threat than an opportunity.

¶11. (SBU) One PSPC member we talked with seemed more optimistic about possible approvals for expansion into new businesses. Both FSA and PSPC are concerned about the level of talent currently at Yucho. Most Yucho employees have worked for the bank for their entire careers and therefore have little or no experience with anything more than the relatively unsophisticated products Yucho currently offers. The PSPC member suggested Yucho might look at tie-ups with firms having the required technical expertise. He specifically mentioned Goldman Sachs and Morgan Stanley, though this specificity was likely calculated to appeal to his American audience. However, a range of views exists, and another PSPC member consistently has asserted the view that Japan Post should focus on shrinking its balance sheet, rather than a major expansion of activities.

¶12. (SBU) Most American observers have concentrated on the privatization of the postal insurance company, probably because the new company will compete directly with U. S. companies already well established in the Japanese insurance market. The Yucho privatization has received less attention because most American banks and other financial institutions, with the notable exception of Citigroup (which has an agreement

with Yucho allowing Citibank savers to use Yucho ATMs), do not have retail banking operations in Japan and are not directly affected by the privatization. Concerns that have been raised include a desire by securities firms to be allowed to compete on asset management service provision to the bank, and a desire to have equal access to the postal network.

But What if Yucho Turns Out to be Less Than its Former Self?
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¶13. (C) A different fear might be called a "weak bank" scenario. Under this model, the new Japan Postal Bank does not have the expertise to enter the various potential lending markets, but feels pressure to do so anyway in order to show a viable business strategy to potential investors before the eventual IPO. Inexperienced loan officers turn out to be unable to poach clients from the regional and city banks and so make ill-advised loans to marginal borrowers. Given the difficulty in developing new products and showing growth in the short time line currently proposed, a number of observers find this scenario credible, at least in part, because of the lack of experience now found in the bank. To counter such a problem, it might be that the GOJ, through the holding company, continues to be involved, limiting outside access to the postal network and thus to Yucho,s depositors until Yucho proves itself a viable entity.

¶14. (SBU) One PSPC member acknowledged that Yucho cannot be viewed as a purely private player before 2017 and promised

the PSPC would be proactive as opposed to reactive like the FTC on anti-monopoly type issues. However, when asked about his interpretation of the terms level playing field and user convenience, he stated he was concerned that regional players are making anti-competitive arguments and that it was important to protect consumers. Arguably, he added, far from needing to wait until 2017 and full privatization, a level playing field requires the postal bank be permitted to enter into a full range of services in order to compete with existing banks. In other words, the danger might not be that the new mammoth postal bank will destroy other banks, but rather the other way around.

Comment

¶15. (C) The size, scope and political history of Japan Post,s privatization leave no room for anything less than complete success. Japan,s policymakers seek to structure the privatized bank as a viable enterprise and increase competition for the benefit of consumers. Some observers, however, express concern Japanese policymakers will create either a strong postal bank that enjoys preferential treatment with the ability to overpower its competitors, or a weak bank that will struggle to meet its service obligations, create market instability, and perhaps ultimately need a government bail-out. The PSPC, charged with shepherding the new Japan Post, will have to steer a middle course to ensure a successful privatization. The committee is likely to face significant pressure from existing banks and other financial institutions to limit the range of new business the postal bank will be allowed to enter. At the same time, many in government want a successful and early IPO, the revenues from which will probably go to reduce Japan,s high public debt load. Striking a balance between these competing interests will be a difficult enterprise without precedent.

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